WORKING PAPER NO. 2

FUTURE STRATEGIES FOR RICE PRICE STABILIZATION IN INDONSIA

BAPPENAS/USAID/DAI FOOD POLICY ADVISORY TEAM
JUNE 1999

Future Strategies for Rice Price Stabilization in Indonesia

Executive Summary

The sources, magnitude, and effects of rice price instability are changing in Indonesia. Coupled with different external realities, these changes suggest that the nature of appropriate stabilization policies in the new environment should be different. The first principle of the new stabilization policy should be to allow more instability and devote attention primarily to the possibility of very large price fluctuations. Because the share of rice in household expenditures and the macro-economy has declined steadily and significantly during the past 30 years, the benefits from any given level of stabilization are significantly lower than they were in the past. The second principle of the new stabilization policy should be that upward price movements will require more policy attention than downward price movements. Large upward domestic price spikes (due to a sharp depreciation of the rupiah, a severe production shortfall, or a severe shortage of rice on the world market) are more likely than large downward price spikes. Furthermore, the poorest members of society, in both urban and rural areas (the landless poor), are net consumers of rice and thus are vulnerable to upward price movements.

A new set of policies that will effectively reduce the risk of large upward price movements would consist of four components: (1) continuation of the OPK program with better targeting; (2) public food security stocks of approximately 500,000 tons; (3) recognition of the need for temporary rice export bans to prevent massive outflows of rice in response to events such as a sharp depreciation of the rupiah or a blowout in world rice prices; and (4) if feasible, non-tradable, government to government rice options with Thailand offer a possible low cost alternative to holding domestic stocks and provide insurance against a severe tightening of the world rice market.

Future Strategies for Rice Price Stabilization in Indonesia

Indonesia has spent a large amount of resources to stabilize rice prices, and generally has been quite successful at doing so. It is likely that any new government will attach some importance to continuing these efforts in one form or another. The sources, magnitude, and effects of rice price instability are changing in Indonesia, however. Coupled with different external realities, these changes suggest that the nature of appropriate stabilization policies in the new environment should be different.

Sources of Rice Price Instability

Three major sources of instability can potentially affect domestic rice prices in Indonesia - - fluctuations in prices on the thin and unstable world rice market, fluctuations in the rupiah foreign exchange rate, and fluctuations in domestic production due to the weather. The first two factors are important because, under the current policy environment, free import and export of rice is allowed.

The World Rice Market: Fortunately, the world rice market appears to be much more stable than it was 25 years ago, when it temporarily closed down during the world food crisis and rice could not be obtained at any price. In the face of a large simultaneous surge in demand from Bangladesh, the Philippines, and Indonesia in 1998, world prices did not increase significantly. Instead, world trade surged to 28 million tons, a level unthinkable just a few years earlier. Although the world rice market showed more flexibility than most observers dreamed possible, it is important to recognize that such flexibility is not guaranteed in the future. Several fortuitous events in 1998 combined to keep the increase in world prices minimal. First, world oil prices were depressed, which reduced rice demand from Iran, Iraq, and Saudi Arabia, all major rice importers. Second, the depreciation of the baht encouraged record exports of 6.4 million tons from Thailand, the world's major rice exporter. Third, world rice production reached a record level in 1997/98, with strong increases occurring in Thailand (10%), Vietnam (6%), and China (3%). Fourth, India was sitting on large stocks due to timely arrival of the monsoons for many consecutive years. These stocks were partially emptied onto world markets and helped to contain

price increases. If the next El Nino were to occur in a period of high oil prices, a stable baht, low world rice production, and low stock levels in India (all reasonable possibilities), it is not clear how the world rice market would react to a surge in Indonesian demand.

Although the favorable outcome in 1998 was partially a matter of luck, underlying trends suggest that the world rice market will continue to be more flexible in the future. In the past, all Asian countries pursued stabilization policies that insulated them from the unstable world rice market. These policies successfully reduced domestic price instability, but they also served to increase world market instability. Production fluctuations in one country could not be "shared" with the domestic markets of other countries, but instead were confined to the very small world market, thus causing large price fluctuations in that market. Recently, however, there has been a movement toward liberalization of international rice trade, although it is still in its infancy. Thailand has moved away from variable export taxes to unrestricted free trade in rice, and Indonesia now allows the private sector to import rice without tariffs. The private sector is also starting to play a larger role in imports to the Philippines. If these trends gather steam in other countries, the world rice market will be more flexible in the future.

The Exchange Rate and Domestic Production: Exchange rate variability will certainly be greater than it was in the past when the rupiah was roughly linked to the US dollar under a crawling peg. The likely effect of these fluctuations on the instability of domestic rice prices is unclear, however. To the extent that the exchange rate fluctuates in a wide band (say, plus or minus 10%), the effects of exchange rate instability on domestic rice price instability will probably be minimal; the additional exchange rate risk may discourage trade if the potential profits are small. On the other hand, there remains the possibility of a large blowout in the exchange rate. Under free trade in rice, such a blowout would have significant effects on domestic rice prices, as private traders would rush to take advantage of any large price discrepancies between domestic and world prices. Future domestic rice production also may be less stable due to higher climatic variability, but at present there is insufficient evidence to conclusively support this argument.

Effects and Asymmetries of Rice Price Instability

It will be important to control domestic rice price instability in Indonesia for at least two reasons. First, unstable rice prices can cause rapid shifts in income distribution, possibly causing social instability. Second, unstable prices can impose significant burdens on the poor, both farmers and consumers.

Any given level of rice price instability will be less disruptive than it was in the past because the share of rice in household expenditures and the macro-economy has declined steadily and significantly during the past 30 years. Whereas rice formerly constituted 45% of the CPI, it now accounts for only about 6%. Because of this trend, the benefits of rice price stabilization are significantly lower than they were in the past, when even relatively minor fluctuations could cause significant hardship for large segments of the population, both farmers and consumers. Now, however, the damaging effects of price instability are felt only when there are very large shifts in prices. Consequently, future rice price stabilization policy should focus on preventing such large fluctuations, with less attention paid to relatively small fluctuations.

Upward price movements will require more policy attention than downward price movements. First, there is a greater probability of very large increases in prices relative to very large decreases in prices. This is true for all three sources of instability mentioned above. For example, the largest disturbances in the world rice market have been on the upside, not the downside. Thus, during the world food crisis of 1973-1975, world rice prices shot up to more than US$1000/ton (in 1998 prices). There has been no comparable shock on the downside. In terms of production disturbances, El Nino can cut production to 8% or more below trend, but there are no comparable weather events that can suddenly increase production in a single year to 8% above trend. A 50% depreciation of the exchange rate over a period of a few months (from Rp 7000/US$ to Rp 10,500/US$) seems more likely than an appreciation of 50% (from Rp 7000/US$ to Rp 3500/US$). (An appreciation would lower rice prices by encouraging imports, while a depreciation would raise rice prices by discouraging

imports or encouraging exports). Thus, there is a much greater risk of a sudden, large increase in domestic rice prices than there is of a sudden, large price decline.

Second, the poorest members of both rural and urban communities are net consumers of rice. This is clearly true in urban areas, where everyone is a net consumer of rice. But it is also true in rural areas, where the landless have much lower income than small rice farmers with one-half to one hectare of land. Small land-owning rice farmers on Java are not rich, but neither are they the poorest of the poor.

Policy Measures to Deal with Future Rice Price Instability

The benefits of traditional stabilization policy are vastly lower today because of the lower share of rice in household budgets and the macro-economy. This suggests that the benefits of the stabilization policy implemented by Bulog since the 1960s no longer exceed the costs. Yet a policy of no government intervention is not a viable option, either. Even if it were politically feasible, it is inconsistent with food security for the poor in the event of large price disturbances.

One alternative might be to implement a trade-based stabilization policy, i.e. a variable quota or variable tariff system. While either of those alternatives would vastly reduce costs at Bulog relative to the old system of varying public stock levels, these policies are still highly vulnerable to rent seeking. They also fail to acknowledge the fundamental shift in the nature of the stabilization task that has occurred. The traditional policy, which worked so well for many years, attempted to shield both consumers and farmers, and to protect them from both relatively small seasonal price fluctuations and inter-annual fluctuations in prices. In the future, however, rice consumers are more likely to face large upside instability than rice farmers are to face large downside instability. The ability of rice consumers to deal with that instability by substituting away from rice is more limited, and the poorest members of society are net rice consumers. Thus, the primary focus of the new stabilization policy must be the prevention of sudden large price shocks on the consumption side of the market. The very real possibility of such large shocks, due to a blowout in either in the world rice market or the foreign exchange market, suggest strong consideration be given to the following new set of policies.

OPK: In the short-run, the most important consideration is the continuation of the targeted rice consumption subsidy (OPK) program. Indonesia currently has no substitute method of protection for poor rice consumers, and it would seem extremely unwise to abandon this program without an appropriate replacement. It will also be important, however, to target the program more narrowly so that it serves primarily those who are truly food insecure in order to conserve scarce budgetary resources. A reduction in the per unit subsidy (currently more than 60%) could complement this effort. Whether this is a viable long-term program is a separate question that probably cannot be answered definitively at present. A possible long-term alternative is a food for work program, which might allow less opportunity for corruption and provide better targeting, so long as the wages in the program are set below market levels.

Whether it be food for work or a minor modification of the current OPK program, it is important that the benefits be provided as food, not as cash. This provides insurance to the poor in the face of rising rice prices. If the benefits of OPK were paid in cash, it is unlikely that the monetary value of benefits could be adjusted upward quickly enough to cope with a rapid surge in domestic rice prices. Under these conditions, the poor might be unable to afford enough rice to meet minimum standards of caloric intake.

For the short-term, it is probably best to have Bulog continue to distribute OPK rice. In the longer-term, however, it would be worthwhile to explore methods whereby the private trade could handle the rice, since private traders are typically more efficient at these marketing activities.

Food Security Stocks: Public stocks will also play a role in food security in the near term, especially in urban areas. Bulog, or a successor agency, is the obvious candidate to hold such stocks on behalf of the government. These stocks can be rotated by "steady-state" buying and selling in urban wholesale markets to avoid quality deterioration. The optimal level of such stocks is likely to be in the neighborhood of 500,000 tons of milled rice (estimated as Bulog's iron stock level of 1 million tons minus 500,000 tons that was intended primarily to cut down on transport costs. This latter component will be unnecessary if stocks are held only in urban centers). These stocks would also be available for use in civil emergencies.

Non-Tradable Options: Another strategy worth consideration is the negotiation and purchase of non-tradable, government to government, rice options with Thailand, the center of the world rice market. Such an option would give Indonesia the right to purchase a specified quantity of rice from Thailand, perhaps 500,000 tons, if the world price of rice reached a very high, pre-set level (the exercise price). Delivery would be guaranteed within a specified period of time. This option would not preclude Indonesia from buying additional quantities on the open spot market. By making the option non-tradable, this would prevent unsupervised and unauthorized trading and speculation on the part of government officials, as sometimes happens in other countries that have decided to hedge risks by using foreign exchange futures and options. A non-tradable option would give Indonesia first chance at Thailand's exports, and it would provide insurance against a repeat of the situation in 1973 when it was impossible to obtain any rice imports at any price. Indonesia would exercise this option only infrequently (perhaps once in 10 or 20 years), but it would have to pay every year for the privilege of holding the option. There is no established market for such options, so neither the cost nor even the possibility of this strategy is clear, and it might be less expensive to hold domestic stocks. If this option could be negotiated with Thailand, it would lower the optimal level of domestic food security stocks.

Emergency Export Bans: Both food security stocks and rice options have a serious shortcoming under a free trade regime, and OPK distributions are vulnerable to the same concern. If trade regulations permit rice to be exported freely, then a surge in world rice prices or a large depreciation of the rupiah will create strong incentives to export as much rice as possible. This earns the country foreign exchange, but will contribute to a sharp rise in domestic rice prices, endangering the welfare of the poor and social stability. Regardless of how many food security stocks are dumped onto the domestic market at such a time, they will have no effect on domestic prices if traders are allowed to export the 95% of the annual crop that is marketed and controlled by the private sector. Under such conditions, it may also be difficult for the government to purchase sufficient supplies for OPK beneficiaries without crowding out purchases by other citizens, leading to the possibility of social unrest.

The only feasible solution to this dilemma is the institution of border controls in times of crisis. Such controls are inconsistent with trends toward trade liberalization, but are crucial for protecting the poor. In practice, it may be difficult to enforce such an export ban fully, especially in traditional exporting areas such as South Sulawesi, but it would seem that, at a minimum, such attempts must be made. Any reduction of exports would be helpful in such a crisis situation, especially since the cost of the policy is small. It is important to acknowledge the possibility that an export ban might be necessary at times for food security, and to build this into both the legal system and contingency planning measures.

Conclusion: In combination, OPK, food security stocks, rice options, and the possibility of an export ban under exceptional circumstances should provide adequate insurance to poor rice consumers in the event of "blowouts" in world rice prices or the rupiah. This new set of policies will result in less stabilization than Bulog was able to achieve historically, but the previous level of stabilization is no longer worth the costs.